Current Federal Tax Developments

Week of September 16, 2019

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ACCOUNTING

CONTINUING EDUCATION

KAPLAN

CURRENT FEDERAL TAX DEVELOPMENTS
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Current Federal Tax Developments

Kaplan Financial Education

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SECTION: 74
CAR AWARDED TO STAND-OUT HIGH SCHOOL SENIOR IN DRAWING IS TAXABLE INCOME

Citation: Conyers v. Commissioner, Designated Order, Case No. 13969-18, 9/11/19

A Tennessee high school student got a lesson on tax law in the case of *Conyers v. Commissioner*, Designated Order, Case No. 13969-18.[1] The former stand-out student discovered that the value of the Jeep Renegade she received as an award that given as a prize in a drawing was taxable income to her, despite being given to her in recognition of outstanding performance her senior year.

To qualify to be part of that drawing, Alejandra had to have perfect attendance her senior year, good grades and be submitted for the drawing by her high school. Alejandra was just such a model student. The program was run by a local car dealership as a "Strive to Drive" competition.[2]

When Ms. Conyers filed her 2016 income tax return, she did not include the value of the prize in her income. However, she was issued a Form 1099MISC that showed a value for the vehicle of $23,780.[3]

Ms. Conyers argued that she should be able to treat the receipt of the car as a gift. Under IRC §102 a gift is excludable from a taxpayer's income. IRC §102(a) provides "[g]ross income does not include the value of property acquired by gift, bequest, devise, or inheritance."

The Tax Court opinion looks at the history of this section, noting that Ms. Conyer's position on how to read IRC §102 did have some support in pre-1954 case law:

> In *Washburn v. Commissioner*,[4] a taxpayer won a cash prize from a radio drawing.
>
> The taxpayer received a phone call from a radio station informing her that she had won the "Pot O' Gold" — a cash prize worth $900. The taxpayer did not enter into the drawing, but was selected randomly out

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[1] https://www.ustaxcourt.gov/InternetOrders/DocumentViewer.aspx?IndexSearchableOrdersID=300396, September 11, 2019, retrieved September 12, 2019

[2] *Ibid*, p. 1

[3] *Ibid*, p. 2

[4] *Washburn v. Commissioner*, 5 T.C. 1333, 1334 (1945)

> of the phonebook. Once the taxpayer received the money, she had no promotional or service obligations to the donor. We held that, because the taxpayer had no obligations to the donor, the prize was a gift and excludable from her taxable income.
>
> In the decade following *Washburn*, courts held that certain prizes were gifts. In those cases, a prize was treated as a gift for tax purposes when the taxpayer (1) did not enter into the drawing or contest from which the prize was won, and (2) did not promote or provide services for the donor of the prize. These cases varied on how much action was required for a taxpayer to have "entered" a drawing or contest.[5]

So far, so good. Alejandra looked like the taxpayer in *Washburn*, having been submitted by her high school to be part of the contest. But the Court noted that Congress was not happy with the *Washburn* ruling, and in 1954 Congress added an additional provision to the tax law—IRC §74.

That provision was added to the law specifically to overturn the result in *Washburn*, obviously not a good thing for Ms. Conyers. IRC §74(a) specifically states "[e]xcept as otherwise provided in this section or in section 117 (relating to qualified scholarships), gross income includes amounts received as prizes and awards."

The initial version of §74 did have an out that would have helped Alejandra—IRC §74(b) as originally enacted allowed an exclusion for awards in recognition of educational achievement if the recipient was selected without any action on his/her part to enter the contest and the recipients was not required to perform any substantial services in the future.[6]

However, in 1986 Congress again changed the rules—this time adding IRC §74(b)(3) that required the recipient to request that the prize be immediately transferred to a governmental agency or a §170(c) charitable organization to be excluded from the recipient's income.[7] This version of the law remained in place when Alejandra won her vehicle.

Thus, the Court concluded, Ms. Conyers must include the entire value of the value in her income for 2016.

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[5] https://www.ustaxcourt.gov/InternetOrders/DocumentViewer.aspx?IndexSearchableOrdersID=300396, September 11, 2019, retrieved September 12, 2019, pp. 3-4

[6] *Ibid*, p. 5

[7] *Ibid*

The case illustrates some of the traps that taxpayers can fall into as they try and navigate the IRC, traps that advisers can fall into as well. IRC §102 on its face presents a reasonable case for excluding the amount from income—so reasonable, in fact, that courts had done just that in cases like Ms. Conyers.

However, the search for the answer has to consider the possibility that Congress might have enacted a provision that carves out some situations from coverage by the general rule of IRC §102—in this case, the addition of §74 to specifically reverse the results of the decisions that looked so favorable for Ms. Conyers. The more specific rule overrides the general rule, thus making the amount taxable.

SECTION: 451
PROPOSED REGULATIONS ISSUED ON ADVANCE PAYMENT RULES ADDED AT §451(C) BY TCJA

Citation: REG-104554-18, 9/9/19

In the Tax Cuts and Jobs Act, Congress added IRC §451(c) in order to put into the Code an accounting method the IRS had defined in Revenue Procedure 2004-34 to optionally account for advance payments. On September 5, 2019, the IRS released proposed regulations to implement this provision.[8] Specifically, the IRS has proposed to add Proposed Reg. §1.451-8, Advance payments for goods, services and other items to the existing regulations under IRC §451.

The IRS makes clear in the preamble that, for the most part, the proposed regulations will follow the previously existing guidance:

> Because new section 451(c)(1)(B) was intended to generally codify the Revenue Procedure deferral method, the Treasury Department and the IRS believe that rules similar to the Revenue Procedure deferral method are necessary and appropriate for the proper application of section 451(c). See H.R. Rep. No. 115-466, at 429 (2017) (Conf. Rep.).[9]

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[8] REG-104554-18, https://s3.amazonaws.com/public-inspection.federalregister.gov/2019-19197.pdf, September 5, 2019, scheduled to be published in the *Federal Register* on September 9, 2019

[9] *Ibid*, p. 4

Regulation Provides Only Methods to Defer Recognition of an Advance Payment

The regulation begins by noting that the advanced payment deferral methods found in Proposed Reg. §1.451-8(c) or (d) are the sole method to avoid immediate inclusion in income when an advance payment is received by the taxpayer.[10]

Definition of an Advance Payment

The regulations outline what is and is not considered to be an advance payment subject to these rules. An advance payment is a payment received by the taxpayer if:

- Full inclusion of the payment in the taxpayer's income for the year of receipt would otherwise be a permissible method of accounting for tax purposes (that is, no other provision of the IRC requires deferral of recognition);
- Any portion of the payment in question is included by the taxpayer in an applicable financial statement (AFS) for a subsequent taxable year (AFS has the same meaning it does under the revenue conformity regulations for §451(b)[11]); and
- The payment is for:
  - Services;
  - The sale of goods;
  - The use, including by license or lease, of intellectual property, including copyrights, patents, trademarks, service marks, trade names, and similar intangible property rights, such as franchise rights and arena naming rights;
  - The occupancy or use of property if the occupancy or use is ancillary to the provision of services, for example, advance payments for the use of rooms or other quarters in a hotel, booth space at a trade show, campsite space at a mobile home park, and recreational or banquet facilities, or other uses of property, so long as the use is ancillary to the provision of services to the property user;
  - The sale, lease, or license of computer software;
  - Guaranty or warranty contracts ancillary to an item or items described in the preceding bullets;

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[10] Proposed Reg. §1.451-8(a)

[11] Proposed Reg. §1.451-8(b)(2)

- Subscriptions in tangible or intangible format other than those for which an election under section 455 is in effect;
- Memberships in an organization other than those for which an election under section 456 is in effect;
- An eligible gift card sale;
- Any other payment specified by the Secretary in other guidance published in the Internal Revenue Bulletin; or
- Any combination of items described in the preceding bullets.[12]

The following items are specifically *excluded* from being treated as an advance payment:

- Rent, except for those rents specifically included as advance payments in the prior list;
- Insurance premiums, to the extent the inclusion of those premiums is governed by subchapter L;
- Payments with respect to financial instruments (for example, debt instruments, deposits, letters of credit, notional principal contracts, options, forward contracts, futures contracts, foreign currency contracts, credit card agreements (including rewards or loyalty points under such agreements), financial derivatives, or similar items), including purported prepayments of interest;
- Payments with respect to service warranty contracts for which the taxpayer uses the accounting method provided in Revenue Procedure 97-38 (1997-2 CB 479);
- Payments with respect to warranty and guaranty contracts under which a third party is the primary obligor;
- Payments subject to section 871(a) (income of a nonresident alien not connected with the United States), 881(taxation of income of foreign corporations not connected with the United States), 1441 (withholding tax on nonresident aliens), or 1442 (withholding of tax on foreign corporations);
- Payments in property to which section 83 applies (property transferred in connection with the performance of services); and

[12] Proposed Reg. §1.451-8(b)(1)(i)

- Payments received in a taxable year earlier than the taxable year immediately preceding the taxable year of the *contractual delivery date* for a *specified good*.[13]

For purposes of the last item listed, a *specified good* is defined as a good for which:

- During the taxable year a payment is received, the taxpayer does not have on hand (or available to it in such year through its normal source of supply) goods of a substantially similar kind and in a sufficient quantity to satisfy the contract to transfer the good to the customer; and

- All the revenue from the sale of the good is recognized in the taxpayer's AFS in the year of delivery.[14]

The *contractual delivery date* is the month and year of delivery listed in the written contract to the transaction. [15] Thus, a written contract must exist to defer the recognition past the year following the receipt of payment, even if all other conditions for the longer deferral of recognition are met.

An item of gross income is *received* by the taxpayer if it is actually or constructively received, or if it is due and payable to the taxpayer.[16]

Revenue, performance obligation and transaction price, when used in this regulation, has the same meanings they have under Proposed Reg. §1.451-3 that deals with the revenue conformity rule found in IRC §451(b).[17]

Eligible Gift Card Sale

As was noted in the prior section, only *eligible gift card sales* qualify for treatment as a an advance sale for purposes of §451(c). Such a sale is the sale of a gift card or gift certificate if:

- The taxpayer is primarily liable to the customer, or holder of the gift card, for the value of the card until redemption or expiration; and

- The gift card is redeemable by the taxpayer or by any other entity that is legally obligated to the taxpayer to accept the gift card from a customer as payment for

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[13] Proposed Reg. §1.451-8(b)(1)(ii)

[14] Proposed Reg. §1.451-8(b)(9)

[15] Proposed Reg. §1.451-8(b)(8)

[16] Proposed Reg. §1.451-8(b)(5)

[17] Proposed Reg. §1.451-8(b)(4), (6) and (7)

items otherwise eligible for treatment as an advance payment if the payment had been made directly for that item.[18]

Deferral Method for a Taxpayer with an Applicable Financial Statement

The IRS begins by dealing with taxpayers who have an applicable financial statement. Note that the IRC itself only refers to taxpayers with an applicable financial statement under §451(b).[19] However, in a later section we'll find that the IRS has extended the rules to cover those without an AFS, based on the fact that Revenue Procedure 2004-34 also had provisions for taxpayers without an AFS.

A taxpayer with an AFS can elect to use the deferral method under IRC §451(c) if the taxpayer is able to determine the extent to which such advanced payments are included in revenue of the AFS during the taxable year.[20]

A taxpayer using the AFS deferral method must:

- Include the advance payment, or any portion thereof, in gross income in the taxable year of receipt to the extent included in revenue in its AFS; and
- Include the remaining portion of such advance payment in gross income in the taxable year following the taxable year in which such payment is received.[21]

The regulations require that advance payments must be entirely included in gross income in the taxable year of receipt or, if applicable, a short taxable year where the advance payment is not otherwise required to be entirely included in income:

- If, in that taxable year, the taxpayer either dies or ceases to exist in a transaction other than a transaction to which section 381(a) applies; or
- If, and to the extent that, in that taxable year, the taxpayer's obligation with respect to the advance payments is satisfied or otherwise ends other than in:
  - A transaction to which section 381(a) applies; or

[18] Proposed Reg. §1.451-8(b)(3)

[19] IRC §451(c)(1)(B)(i)

[20] Proposed Reg. §1.451-8(c)(1)

[21] Proposed Reg. §1.451-8(c)(1)

- A section 351(a) transfer that is part of a section 351 transaction in which:
  - Substantially all assets of the trade or business (including advance payments) are transferred;
  - The transferee adopts or uses the deferral method in the year of transfer; and
  - The transferee and the transferor are members of the same consolidated group, as defined in §1.1502-1(h).[22]

The regulations provide the following example:

EXAMPLE (PROPOSED REG. §1.451-8(C)(2)(III))

Ceasing to Exist

A is a calendar year taxpayer and is in the business of selling and licensing computer software (off the shelf, fully customized, and semi-customized) and providing customer support. On July 1, 2018, A enters into a 2- year software maintenance contract and receives an advance payment. Under the contract, A will provide software updates if it develops an update within the contract period, as well as online and telephone customer support. A ceases to exist on December 1, 2018, in a transaction that does not involve a section 351(a) transfer described in paragraph (c)(2)(i)(B)(2) of this section and is not a transaction to which section 381(a) applies. For federal income tax purposes, A must include the entire advance payment in gross income in its 2018 taxable year.

If there is a financial statement adjustment where a taxpayer treats an advance payment as an item of deferred income in its AFS and it writes down or adjusts the item (or some portion) directly to an equity account, the amount is to be included in income.[23]

[22] Proposed Reg. §1.451-8(c)(2)

[23] Proposed Reg. §1.451-8(c)(3)(i)

The IRS provides the following examples related to applying the adjustment rule:

EXAMPLE (PROPOSED REG. §1.451-8(C)(3)(II))

Example 1

On May 1, 2018, A, a corporation that files its federal income tax return on a calendar year basis, received $100 as an advance payment for a 2-year contract to provide services. For financial accounting purposes, A recorded $100 as a deferred revenue liability in its AFS, expecting to report 1/4 of the advance payment in revenue in its AFS for 2018, 1/2 for 2019, and 1/4 for 2020. On August 31, 2018, C, an unrelated corporation that files its federal income tax return on a calendar year basis, acquired all of the stock of A, and A joined C's consolidated group. A's short taxable year ended on August 31, 2018, and, as of that date, A had included only 1/4 ($25) of the advance payment in revenue in its AFS. On September 1, 2018, after the stock acquisition, and in accordance with purchase accounting rules, C wrote down A's deferred revenue liability to its fair value of $10 as of the date of the acquisition. The $10 will be included in revenue on A's AFS in accordance with the method of accounting A uses for financial accounting purposes. For federal income tax purposes, A uses the deferral method. For federal income tax purposes, A must take 1/4 ($25) of the advance payment into income for its short taxable year ending August 31, 2018, and the remainder of the advance payment ($75) ($65 write down + $10 future financial statement revenue) must be included in income for A's next succeeding taxable year.

Example 2

On May 1, 2018, B, a corporation that files its federal income tax return on a calendar year basis, received $100 advance payment for a contract to be performed in 2018, 2019, and 2020. On August 31, 2018, D, a corporation that is not consolidated for federal income tax purposes, acquired all of the stock of B. Before the stock acquisition, on its AFS for 2018, B included $40 of the advance payment in revenue, and $60 as a deferred revenue liability. On September 1, 2018, after the stock acquisition and in accordance with purchase accounting rules, D wrote down its $60 deferred revenue liability to $10 (its fair value) as of the date of the acquisition. After the acquisition, B does not include in revenue any of the $10 deferred revenue liability in its 2018 AFS. B does include $5 in revenue in 2019, and $5 in revenue in 2020. For federal income tax purposes, B uses the deferral method. For federal income tax purposes, B must take $40 of the advance payment into income in 2018, and the remainder of the advance payment ($60) ($50 write down + $10 future financial statement revenue) must be included in income for B's next succeeding taxable year, 2019.

A special rules applies if the succeeding taxable year is a short taxable year of 92 days or less. In that case, the taxpayer will include amounts related to advance payments initially treated under the deferral method in the prior year only to the extent the advance payment is included in income in the AFS for the short year. The remaining balance (if any) will be included in income in the following year.[24]

[24] Proposed Reg. §1.451-8(c)(4)(i)

EXAMPLE (PROPOSED REG. §1.451-8(C)(4)(II))

A is a calendar year taxpayer and is in the business of selling and licensing computer software (off the shelf, fully customized, and semi-customized) and providing customer support. On July 1, 2018, A receives an advance payment for a 2- year software maintenance contract. Under the contract, A will provide software updates if it develops an update within the contract period, as well as online and telephone customer support. A changes its taxable period to a fiscal year ending March 31 so that A has a short taxable year beginning January 1, 2019, and ending March 31, 2019. In its AFS, A includes 1/4 of the payment in revenue for the taxable year ending December 31, 2018; 1/6 in revenue for the short taxable year ending March 31, 2019; 1/4 in revenue for the taxable year ending March 31, 2020; and 1/4 in revenue for the taxable year ending March 31, 2021. Because the taxable year ending March 31, 2019, is 92 days or less, A must include 1/4 of the payment in gross income for the taxable year ending December 31, 2018, 1/6 in gross income for the short taxable year ending March 31, 2019, and the remaining amount in gross income for the taxable year ending March 31, 2020.

If an eligible gift card is redeemable by another entity whose financial results are not included in the AFS for the taxpayer, a payment is treated as included in the taxpayer's AFS to the extent the gift card is redeemed by the other entity during the tax year.[25]

The IRS includes 25 examples, covering different types of advance payments, at Proposed Reg. §1.451-8(c)(8).

Deferral Method for Taxpayers Without an AFS

As was noted earlier, the provision at IRC §451(c) added by the TCJA could not be applied to a taxpayer without an AFS, since the determination of the amount to include in income is determined in the law by reference to the IRC §451(b) AFS.[26] But the IRS justified adding a non-AFS rule even thought law did not apply to taxpayers without an AFS in the preamble by stating:

> The Treasury Department and the IRS have concluded that section 451(c) does not prohibit a deferral method that is otherwise permissible under Revenue Procedure 2004-34. See H.R. Rep. No. 115-466, at 429 (2017) (Conf. Rep.). See also, Joint Committee on Taxation, General Explanation of Public Law 115-97 (JCS-1-18) at 170-171 (Dec. 20, 2018). Revenue Procedure 2004- 34 permitted non-AFS taxpayers to use the Revenue Procedure deferral method based on when the income is earned (earned standard). See section 5.02(3)(b) of Revenue Procedure 2004-34. The Revenue Procedure deferral method using the earned standard is a permissible method of accounting for non-AFS taxpayers and, therefore, these proposed

[25] Proposed Reg. §1.451-8(c)(7)

[26] IRC §451(c)(1)(B)(i)

regulations also provide a similar deferral method for non-AFS taxpayers in proposed §1.451-8(d) (non-AFS deferral method).[27]

The *non-AFS deferral method* is available to taxpayers without an applicable financial statement as defined in IRC §451(b) and requires:

- The taxpayer be able to determine when the extent to which advance payments are included in income in the year of receipt or, if applicable, a short taxable year.[28] That amount is included in income in the year of receipt up to the amount that is earned in that year;[29] and
- The remaining amount is included in income in the following year.[30]

An amount is treated as earned for a taxpayer without an AFS when the all events test described in Reg. §1.451-1(a), without regard to when the payment is received.[31] If a taxpayer is unable to determine the extent to which a payment is earned in the year of receipt, the taxpayer may determine the amount:

- On a statistical basis if adequate data are available to the taxpayer;
- On a straight line ratable basis over the term of the agreement if the taxpayer receives advance payments under a fixed term agreement and if it is not unreasonable to anticipate at the end of the taxable year of receipt that the advance payment will be earned ratably over the term of the agreement; or
- By the use of any other basis that in the opinion of the Commissioner results in a clear reflection of income.[32]

Allocation of Income for Contracts with More Than One Obligation

If a taxpayer without an AFS receives a payment that is attributable to more than one eligible item, the taxpayer must allocate the payment among the items in a manner that

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[27] REG-104554-18, https://s3.amazonaws.com/public-inspection.federalregister.gov/2019-19197.pdf, September 5, 2019, scheduled to be published in the Federal Register on September 9, 2019, p. 5

[28] Proposed Reg. §1.451-8(d)(2)

[29] Proposed Reg. §1.451-8(d)(4)

[30] Proposed Reg. §1.451-8(d)(4)

[31] Proposed Reg. §1.451-8(d)(4)(ii)

[32] Proposed Reg. §1.451-8(d)(4)(ii)

is based on an objective criteria.[33] The regulation provides that an allocation method is based on objective criteria if:

- The allocation method is based on payments the taxpayer regularly receives for an item or items it regularly sells or provides separately; or
- It is based on a method that may be provided in guidance published in the Internal Revenue Bulletin.[34]

Other Rules for Taxpayers Without an AFS

Rules like those for a taxpayer with an AFS apply in the following situations:

- For financial statement adjustments, rules similar to those described earlier under Proposed Reg. §1.451-8(c)(3) (describing direct charges to equity accounts);[35]
- A similar short taxable year rule for years of 92 days or less that is found in Proposed Reg. §1.451-8(c)(4) will apply;[36] and
- As well, the same eligible gift card redemption rule as applies to taxpayers with an AFR will apply to those without an AFS.[37]

Method of Accounting Issue

The use of either the AFS deferral method or the non-AFS deferral method will be treated a method of accounting for tax purposes under IRC §446, triggering the IRS requirements for permission to change methods. Similarly, a change in the method of recognizing advance payments in an AFS that changes or could change the timing of inclusion in income is a change of accounting method. That would cover a change in the timing of recognition mandated by FASB through a future Accounting Standards Update.[38]

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[33] Proposed Reg. §1.451-8(d)(5)(i)

[34] Proposed Reg. §1.451-8(d)(5)(ii)

[35] Proposed Reg. §1.451-8(d)(6)

[36] Proposed Reg. §1.451-8(d)(7)

[37] Proposed Reg. §1.451-8(d)(8)

[38] Proposed Reg. §1.451-8(e)

Any such changes in method can only be undertaken if the taxpayer has obtained the permission of the IRS to make the change.[39]

The IRS released Revenue Procedure 2019-37[40] that provides automatic permission procedures for taxpayers making the change to use the new advance payment codified rules under IRC §451(c). Note that the procedure offers taxpayers options to either use a §481(a) or cut-off adjustment in most cases.

SECTION: 451
PROPOSED REGULATIONS RELEASED ON AFS REVENUE CONFORMITY RULE OF §451(B)

Citation: REG-104870-18, 9/9/19

The IRS has released proposed regulations related to the §451(b) revenue conformity rule for taxpayers with applicable financial statements that was added by the Tax Cuts and Jobs Act.[41] The major portion of the proposed regulations is found in Proposed Reg. §1.451-3, Timing of income inclusion for taxpayers with an applicable financial statement using the accrual method of accounting.

The "all events test" for determining when revenue is recognized by taxpayers on the overall accrual method of accounting for tax is summarized by the IRS in the preamble to the proposed regulations as follows:

> Under §1.451-1, accrual method taxpayers generally include items of income in gross income in the taxable year when all the events occur that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy (the all events test). All the events that fix the right to receive income occur when (1) the required performance takes place, (2) payment is due, or (3) payment is made, whichever happens first. Revenue Ruling 2003-10 (2003-1 CB 288); Revenue Ruling 84-31 (1984-1 CB 127); Revenue Ruling 80- 308 (1980-2 CB 162).[42]

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[39] Proposed Reg. §1.451-8(e)

[40] https://www.irs.gov/pub/irs-drop/rp-19-37.pdf, September 6, 2019, retrieved September 7, 2019

[41] REG-104870-18, https://s3.amazonaws.com/public-inspection.federalregister.gov/2019-19325.pdf, release September 5, 2019, scheduled for publication September 9, 2019, retrieved September 5, 2019

[42] *Ibid*, p. 3

The proposed regulations' preamble summarizes the issues, and the impact of the changes made by FASB in ASC 606, *Revenue from Contracts with Customers* as follows:

> Section 451(b)(1) generally provides that, for an accrual method taxpayer with an AFS[43] or other specified financial statement, the all events test with respect to any item of gross income, or portion thereof, is not treated as met any later than when such item, or portion thereof, has been taken into account as revenue in an AFS or other specified financial statement (the AFS income inclusion rule). The AFS income inclusion rule generally increases financial accounting and tax accounting conformity. On May 28, 2014, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) jointly announced new financial accounting standards for revenue recognition, titled "*Revenue from Contracts with Customers (Topic 606)*." See ASC Topic 606 and IASB International Financial Reporting Standard (IFRS) 15 (New Standards). Under the New Standards, items of income may be included as revenue in an AFS earlier than they would have been included in income under the all events test prior to the Act.[44]

The rules apply to taxpayers using the overall accrual method of accounting who have an applicable financial statement.[45] The regulations provide additional details on what constitutes an applicable financial statement.

Applicable Financial Statements

Proposed Reg. §1.451-3(c)(1) defines an applicable financial statement (AFS) as the statement with the highest priority in the following classes, listed in order of descending priority:

- **GAAP Statements:** A statement certified as being prepared in accordance with generally accepted accounting principles and is:
  - A Form 10-K (or successor form), or annual statement to shareholders, filed with the SEC;

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[43] Applicable financial statement

[44] REG-104870-18, https://s3.amazonaws.com/public-inspection.federalregister.gov/2019-19325.pdf, release September 5, 2019, scheduled for publication September 9, 2019, retrieved September 5, 2019, pp. 4-5

[45] IRC §451(b)(1)

- An audited financial statement used for credit purposes, reporting to shareholders, partners or other equity holders or to beneficiaries or any other substantial non-tax purpose; or

- A financial statement, other than a tax return, filed with the Federal government, any federal agency, other than the SEC or IRS.[46]

- **IFRS Statements:** A statement certified as being prepared in accordance with international financial reporting standards and is

  - Filed with an agency of a foreign government equivalent to the SEC and has reporting requirements at least as stringent as the SEC;

  - An audited financial statement used for credit purposes, reporting to shareholders, partners or other equity holders or to beneficiaries or any other substantial non-tax purpose; or

  - A financial statement, other than a tax return, filed with the Federal government, any federal agency, other than the SEC or IRS, or a foreign government or agency of a foreign government, other than an agency that is equivalent to the SEC or IRS;[47] or

- **Other Statements:** A financial statement, other than a tax return, filed with the Federal government, any federal agency, a state government agency or state agency, or a self-regulatory organization. As well, the IRS may provide additional qualifying statements by publishing guidance in the Internal Revenue Bulletin.[48]

If a taxpayer restates revenue in an AFS prior to the date the taxpayer files its Federal income tax return for the taxable year, for purposes of establishing priority, the restated AFS must be used rather than the original AFS. Similarly, if a taxpayer with different financial and taxable years is required to file both annual financial statements and periodic financial statements covering less than a year with a governmental agency, the taxpayer must use the annual statement to determine priority.[49]

If less than all of the tax year is covered by an AFS, the taxpayer is not subject to the revenue conformity rule of §451(b).[50] Similarly, the preamble notes that the test is applied on a year-by-year basis, so if an entity has an AFS in some years and does not

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[46] Proposed Reg. §1.451-3(c)(1)(i)

[47] Proposed Reg. §1.451-3(c)(ii)

[48] Proposed Reg. §1.451-3(c)(iii)

[49] Proposed Reg. §1.451-3(c)(iv)

[50] Proposed Reg. §1.451-3(d)

have an AFS in others, the rules are applied only in the years when the entity has an AFS.[51]

When Revenue is Taken Into Account for Tax Purposes

For taxpayers covered by this rule, the *all events test* is deemed met with respect to any item of gross income no later than when that item is taken into account as revenue in the taxpayer's AFS. The regulations refer to this as *AFS income inclusion rule*.[52] Generally, if the taxpayer is using a tax method of accounting that does not refer to the all events test to determine when the item is recognized in income.[53]

The regulation provides the following examples of tax methods of accounting to which the AFS income inclusion rule does not apply:

- The crop method of accounting under sections 61 and 162;
- Methods of accounting provided in sections 453 through 460 (note that includes long term contract methods, such as percentage of completion and completed contract);
- Methods of accounting for hedging transactions under §1.446-4;
- Methods of accounting for REMIC inducement fees under §1.446-6;
- Methods of accounting for gain on shares in a money market fund under §1.446-7;
- Methods of accounting for certain rental payments under section 467;
- The mark-to-market method of accounting under section 475;
- Timing rules for income and gain associated with a transaction that is integrated under §1.988-5, and income and gain under the nonfunctional currency contingent payment debt instrument rules in §1.988-6;
- Except as otherwise provided in paragraph (i) of the proposed regulations, timing rules for original issue discount (OID) under section 811(b)(3) or 1272 (and the regulations under section 1272), income under the contingent payment debt instrument rules in §1.1275- 4, income under the variable rate debt instrument rules in §1.1275-5, income and gain associated with a transaction that is integrated

[51] REG-104870-18, https://s3.amazonaws.com/public-inspection.federalregister.gov/2019-19325.pdf, release September 5, 2019, scheduled for publication September 9, 2019, retrieved September 5, 2019, p. 5

[52] Proposed Reg. §1.451-3(b)

[53] Proposed Reg. §1.451-3(c)(4)

under §1.1275-6, and income under the inflation-indexed debt instrument rules in §1.1275-7;

- Timing rules for de minimis OID under §1.1273-1(d) and for de minimis market discount (as defined in section 1278(a)(2)(C));
- Timing rules for accrued market discount under sections 1276 and 1278(b); and
- Methods of accounting provided in sections 1502 and 1503 and the regulations thereunder, including the method of accounting relating to intercompany transactions under §1.1502-13.[54]

For purposes of this rule, revenue is defined as all transaction price amounts includable in gross income under IRC §61—the characterization of a transaction price in an AFS does *not* determine if it's included in revenue for these purposes. For example, the fact that an item is included in other comprehensive income on the AFS does not remove it from revenue for purposes of the AFS conformity rule.[55]

The *transaction price* is defined in Proposed Reg. §1.451-3(c)(6) as the gross amount of consideration to which a taxpayer expects to be entitled for AFS purposes in exchange for transferring promised goods, services or other property. However, the transaction price does not include the following:

- Amounts collected on behalf of third parties (for example, some sales taxes) that are otherwise not income to the taxpayer;
- Increases in consideration to which a taxpayer's entitlement is contingent on the occurrence or nonoccurrence of a future event (for example, bonuses contingent on performance and insurance contract commissions contingent on renewal) for the period in which the amount is contingent. However, the regulation presumes that consideration is not contingent unless, based on all relevant facts and circumstances, the taxpayer can establish the contingency to the satisfaction of the IRS. However, an amount will *not* be considered contingent if:
  - The amount is actually or constructively received;
  - The amount is due and payable; or
  - The taxpayer has an enforceable right to payment for performance completed to date.

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[54] Proposed Reg. §1.451-3(c)(5)(i)-(xi)

[55] Proposed Reg. §1.451-3(c)(4)

- Reductions for amounts subject to §461 (year of deduction) including allowances, adjustments, rebates, chargebacks, refunds, rewards (for example, estimated redemption costs associated with loyalty programs), and amounts included in costs of goods sold.[56]

The preamble contains some additional commentary on the interaction of variable consideration under ASC 606 and the regulations, noting:

> Commenters raised concerns about the interaction between sections 61 and 461 with the AFS income inclusion rule. For AFS purposes, taxpayers may be required to include variable consideration when determining the transaction price of a contract. Under the New Standards, variable consideration includes items such as discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties, and other similar items. Variable consideration may also include promised consideration that taxpayers are not yet entitled to under the contract because it is contingent on the occurrence or nonoccurrence of a future event. For Federal income tax purposes, these items of variable consideration may be contingent future income under section 61 or liabilities subject to section 461. Section 451(b) could be read to accelerate the timing of contingent future income and liabilities to match their inclusion in revenue for AFS purposes. However, section 451(b) was intended to change only the timing of income to ensure that those items of income are not included later than when they are included for AFS purposes. See H.R. Rep. No. 115-466, at 428 fn. 874 (2017) (Conf. Rep.) and Joint Committee on Taxation, General Explanation of Public Law 115-97 (JCS-1-18) at 166 (Dec. 20, 2018). Accordingly, proposed §1.451-3(c)(6) provides that the transaction price that is used to determine whether an amount has been included in revenue does not include items to which a taxpayer's entitlement is contingent on the occurrence or nonoccurrence of a future event, reductions for amounts subject to section 461 (including allowances, adjustments, rebates, chargebacks, refunds, rewards, and amounts included in the cost of goods sold), and amounts collected for third parties. However, in order to reduce compliance burden and prevent abuse and undue administrative burden, proposed §1.451-3(c)(6) presumes that an amount included in the transaction price for AFS purposes is not contingent future income unless, upon examination of all of the facts and circumstances existing at the end of the taxable year, it can be established to the

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[56] Proposed Reg. §1.451-3(c)(6)

> satisfaction of the Commissioner that the amount is contingent on the occurrence or nonoccurrence of a future event.[57]

If a transaction has multiple performance obligations, the transaction price is allocated to the performance obligations as it is in the AFS.[58] A *performance obligation* is defined as "a promise in a contract with a customer to transfer to the customer either a good or service, or a combination of both, that is distinct; or a series of distinct goods or services, or a combination of both, that are substantially the same and that have the same pattern of transfer to the customer."[59]

The regulations provide the following example of the application of the performance obligation rule.

EXAMPLE (PROPOSED REG. §1.451-3(G)(2))

Taxpayer A, a manufacturer and servicer of airplane parts, is a calendar-year accrual method taxpayer with an AFS. In 2018, A enters into a $100x contract to sell airplane parts and to service those parts, as necessary, in 2018, 2019, and 2020. For AFS purposes, A allocates $40x of the total contract price to the delivery of parts in 2018, $10x to the provision of services in 2018, $20x to the provision of services in 2019, and $30x to the provision of services in 2020. In 2018, A delivers parts and provides services. On its 2018 AFS, A includes the $40x for the delivery of parts and the $10x for the provision of services in revenue. Under paragraph (g)(1) of this section, because the contract involves multiple performance obligations, A must use its transaction price AFS allocation to determine whether income from the sale of airplane parts and services are included in revenue in its AFS for purposes of this section. Accordingly, under the AFS income inclusion rule in paragraph (b) of this section, for the $40x sale of airplane parts and the $10x provision of services in 2018 the all events test is not met any later than A's 2018 taxable year.

The AFS income exclusion rule also does not apply to items of income related to a mortgage servicing contracts.[60] The preamble explains this exclusion as follows:

> A letter addressed to the Treasury Department indicated that it is unclear whether this exclusion can be applied to income relating to interest rate lock commitments (IRLCs) entered into by mortgage lenders. The proposed regulations do not address this issue because section 475 generally would require mortgage lenders to include

[57] REG-104870-18, https://s3.amazonaws.com/public-inspection.federalregister.gov/2019-19325.pdf, release September 5, 2019, scheduled for publication September 9, 2019, retrieved September 5, 2019, pp. 7-8

[58] Proposed Reg. §1.451-3(g)

[59] Proposed Reg. §1.451-3(c)(3). Note that this definition is similar to that found in ASC 606.

[60] Proposed Reg. §1.451-3(d)

> income relating to IRLCs in taxable income in accordance with the mark-to-market method of accounting. As a result, a mortgage lender generally would not apply section 451(b) to determine when income relating to IRLCs is includible in income.[61]

Cost of Sales Matching

Prior to the issuance of the proposed regulations, many commentators had lobbied the IRS to provide a similar matching system for costs related to revenue. As written, IRC §451(b) only conforms revenue but does not bring along other costs.

The IRS has not provided such a matching rule in the proposed regulations. The preamble discuss the issue as follows:

> Multiple commenters proposed allowing a cost offset when income is included under the AFS income inclusion rule. For example, one commenter suggested that, in determining the amount of income to include under section 451(b), taxpayers selling goods should reduce AFS revenue by the cost of goods sold associated with a sale that does not presently reduce AFS revenue. The commenter acknowledged that costs are not taken into account for Federal income tax purposes until the all events test is satisfied, which includes the economic performance rules under section 461. Because of the resulting inconsistency with sections 461 and 471, these regulations do not follow the commenter's suggestion that a cost offset or cost of goods sold reduction should apply without regard to the economic performance rules of section 461 and inventory accounting rules of section 471.
>
> Congress has addressed various cost recovery mechanisms in the past. In 1955, Congress repealed the reserve method for estimated expenses under section 462 of the Code. See An Act to Repeal Sections 452 and 462 of the Internal Revenue Code of 1954, Public Law No. 84-74, section 1(b) (1955). Section 462 of the Code was a companion to section 452, which allowed taxpayers to report certain types of prepaid income over time. In the Senate Report discussing the repeal of sections 452 and 462, Congress noted that "the problem presented by section 462 is that of the timing of deductions when a taxpayer changes accounting methods." S. Rep. 84-372, at 4 (1955). The Senate noted that taxpayers would be entitled to the deductions even without section 462. In addition, section 462 increased the possibility

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[61] REG-104870-18, https://s3.amazonaws.com/public-inspection.federalregister.gov/2019-19325.pdf, release September 5, 2019, scheduled for publication September 9, 2019, retrieved September 5, 2019, p. 6

> of distortions of income because expenses were being deducted when the amount had not yet been incurred.
>
> Thirty years later, Congress repealed the use of the reserve method for determining losses from bad debts under section 166 in the Tax Reform Act of 1986. In repealing the reserve method, Congress noted that this method was inconsistent with the rules for other deductions under the all events test and could result in deductions being allowed for Federal income tax purposes for losses that may never occur. S. Rep. No. 99-313, at 155 (1986). Moreover, "if a deduction is allowed prior to the taxable year in which the loss occurs, the value of the deduction to the taxpayer will be overstated." S. Rep. No. 99-313, at 155 (1986).
>
> These proposed regulations do not allow a cost offset provision because similar potential distortions of income could result. An allowance to account for future cost of goods sold, for future estimated costs, or other cost offsets also is inconsistent with sections 461 (in particular section 461(h)), 263A, and 471, and the regulations under those sections. In addition, these proposed regulations do not allow a cost offset provision because there is nothing in the statute or legislative history that indicates that in amending section 451 Congress intended to change sections 461, 263A or 471, and the regulations under those sections. See also, General Explanation of Public Law 115- 97 (JCS-1-18) at 150-151, and 164-165 (Dec. 20, 2018).[62]

However, the IRS does concede that perhaps some sort of accommodation should be made. To that end, the preamble continues with the following request for comments that specifically mention expanding the use of percentage of completion method as an option for more taxpayers:

> Nevertheless, the Treasury Department and the IRS continue to consider whether any exceptions are an appropriate use of the Secretary's authority under section 461(h) or 460. To facilitate further consideration of any potential exceptions, detailed comments that specifically address the following issues are requested:
>
> 1. Under what authority would it be appropriate for the Secretary to permit a taxpayer to use a book percentage-of-completion method (PCM) as its tax method? When inventory is involved, what limitations could be instituted to ensure that book PCM could not be used to recover costs related to inventoriable goods prior to the time when such costs could be recovered under sections 471 and 263A?

[62] *Ibid*, pp. 16-18

> Under what specific authority would it be appropriate to permit a book PCM method to be used to recover costs related to inventoriable goods?
>
> 2. Would elective use of book PCM for tax purposes provide an appropriate cost offset? Would such a method be characterized as one that reports contract revenue according to a taxpayer's book method, while accounting for costs, including nondeductible costs, as deductions under the Code? If not, how would such a method account for costs for Federal income tax purposes?
>
> 3. Rather than make book PCM elective, would it be appropriate for the definition of "unique item" for purposes of section 460 to be expanded?
>
> 4. Section 460 requires use of the look-back method to compensate for improper acceleration or deferral of income under PCM. It also requires that all contract income be reported no later than the year following contract completion. Would elective use of a PCM under section 460 without these provisions invite abuse? If so, how could such abuse be prevented?[63]

Items for Which There Is No Change in the Tax Law Treatment

The AFS income inclusion rule does not change the treatment of a transaction for federal tax purposes. Proposed Reg. §1.451-3(e) provides the following list of items whose treatment is not changed by the AFS income inclusion rule:

> (1) A transaction treated as a lease, license, or similar transaction for Federal income tax purposes that is treated as a sale or financing for AFS purposes, and vice versa;
>
> (2) A transaction that is not required to be marked-to-market for Federal income tax purposes but that is marked-to-market for AFS purposes;
>
> (3) Asset sale and liquidation treatment under section 336(e) or 338(h)(10);
>
> (4) A distribution of a corporation or the allocable share of partnership items or an income inclusion under section 951, 951A, or 1293(a) for Federal income tax purposes that is accounted for under the equity method for AFS purposes;

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[63] *Ibid*, pp. 18-19

> (5) A distribution of previously taxed earnings and profits of a foreign corporation; and
>
> (6) A deposit or conduit payment for Federal income tax purposes that is treated as revenue for AFS purposes.[64]

As well, the AFS inclusion rules do not override any provision in the IRC that excludes an item from income or which is a non-recognition transaction. The regulation provides the following examples of such items that are not impacted by the AFS income inclusion rule:

> (1) Any non-recognition transaction, within the meaning of section 7701(a)(45), (for example, a liquidation described in sections 332 and 337, an exchange described in section 351, a distribution described in section 355, a reorganization described in section 368, a contribution described in section 721, or transactions described in sections 1031 through 1045); and
>
> (2) Items specifically excluded from income under sections 101 through 140.[65]

The second category includes items such as death benefits from life insurance policies, municipal bond interest, and cancellation of indebtedness excluded under a provision of §108.

AFS Covering a Group of Entities

If an AFS covers a group of entities, generally the taxpayer's AFS is the group's AFS unless the taxpayer's financial results are separately reported on another AFS of equal or

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[64] Proposed Reg. §1.451-3(e)

[65] Proposed Reg. §1.451-3(f)

higher priority. In that case, the taxpayer's separate AFS becomes the AFS the taxpayer must use.[66]

EXAMPLE (PROPOSED REG. §1.451-3(H)(1)(II))

Taxpayer B, a reseller of computers and electronics, is a calendar year accrual method taxpayer. In 2018, B's financial results are included in its parent corporation's consolidated Form 10-K filed with the SEC, but it files a separate Federal income tax return. Under paragraph (h)(1) of this section, because its financial results are reported on the AFS for its parent corporation, B must use its parent corporation's consolidated Form 10-K as its AFS. Accordingly, under the AFS income inclusion rule in paragraph (b) of this section, for the sale of computers and electronics the all events test is not met any later than when the sale is included in its parent corporation's consolidated Form 10-K.

If a group's AFS is treated as the taxpayer's AFS, the taxpayer must first look to separately stated items on the AFS to determine the amount of revenue allocated to the taxpayer.[67] If the AFS does not separately state items, the amount of revenue allocable to the taxpayer must be determined by relying on source documents used to create the group's AFS.[68]

Difference in AFS Year End and Tax Fiscal Year-End

The regulations have to deal with a situation where the AFS has a year-end that is not the same as the tax year-end. To deal with this, Reg. §1.451-3(h)(4) provides three options that the taxpayer chooses from in this situation.

> (A) The taxpayer computes revenue by using the accounting principles used to create its AFS to determine whether an item would be included in revenue in an AFS for the taxable year as if its financial reporting period was the same as its taxable year, for example, by conducting an interim closing of its books.
>
> (B) The taxpayer computes revenue by including a pro rata portion of the revenue for each financial accounting year that includes any part of the taxpayer's taxable year. If the taxpayer's AFS for part of the taxable year is not available by the due date of the return (with extension), the taxpayer must make a reasonable estimate of revenue for the pro rata portion of the taxable year for which an AFS is not yet available. See §1.451-1(a) for adjustments after actual amounts are determined.

[66] Proposed Reg. §1.451-3(h)(1)

[67] Proposed Reg. §1.451-3(h)(2)

[68] Proposed Reg. §1.451-3(h)(3)

> (C) If a taxpayer's financial accounting year ends five or more months after the end of its taxable year, the taxpayer computes revenue for Federal income tax purposes based on the revenue reported on the AFS prepared for the financial accounting year ending within the taxpayer's taxable year. For purposes of this paragraph (h)(4)(ii)(C), if a taxpayer uses a 52-53 week year for financial accounting or Federal income tax purposes, the last day of such year shall be deemed to occur on the last day of the calendar month ending closest to the end of such year.[69]

The selection of one of these options is treated as a method of accounting. Thus, if a taxpayer wishes to change the method being used to handle the year-end differences, the taxpayer must obtain IRS approval and file a Form 3115.[70]

While some might complain they don't keep their records in a form that allows the use of the methods, the preamble makes it clear that the IRS believes the requirements to keep adequate books and records found in IRC §6001 requires taxpayers in these situations to keep records adequate to handle these issues. So even an entity might not currently have access to such information, the IRS view is that the law requires organizations to revise systems to make such information available.[71]

Restatement of AFS and Accounting Method Changes

The regulations remind taxpayers that the tax method of accounting rules are not governed by FASB rules—once they are adopted for tax purposes, they must have IRS approval for a change even if the taxpayer discovers its AFS treatment wasn't appropriate under GAAP rules.

So if a taxpayer restates its revenue on an AFS and it changes the timing of inclusion of income, that is a change of accounting method and will require the consent of the IRS.[72]

Alternatively, if a taxpayer restates its AFS to correct an error or the change results in a change in the estimate of prorated revenue due to differing fiscal year-end, the taxpayer

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[69] Proposed Reg. §1.451-3(h)(4)(ii)

[70] Proposed Reg. §1.451-3(h)(4)(iii)

[71] REG-104870-18, https://s3.amazonaws.com/public-inspection.federalregister.gov/2019-19325.pdf, release September 5, 2019, scheduled for publication September 9, 2019, retrieved September 5, 2019, p. 15

[72] Proposed Reg. §1.451-3(h)(5)

is advised to consult Reg. §1.451-1(a),[73] where the following is found at the end of the provision:

> If a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. Similarly, if a taxpayer ascertains that an item was improperly included in gross income in a prior taxable year, he should, if within the period of limitation, file claim for credit or refund of any overpayment of tax arising therefrom.[74]

Special Rules for Certain Items of Income with Respect to Debt Instruments

For specified debt instruments, the regulations provide that the AFS income inclusion rule takes precedence over the OID rules for certain fees. As the regulation provides:

> If an item of income, or portion thereof, with respect to a debt instrument is described in paragraph (i)(2) of this section, the rules of this section apply before the rules in sections 1271 through 1275 and §§1.1271-1 through 1.1275-7 (OID rules). Therefore, an item of income, or portion thereof, described in paragraph (i)(2) of this section may not be taken into income later than when that item, or portion thereof, is taken into account as revenue in the taxpayer's AFS, regardless of whether the timing of income inclusion for that item is normally determined using a special method of accounting. See also §1.1275-2(l) for the treatment of the items described in paragraph (i)(2) of this section under the OID rules.[75]

The specified fees rule is described as follows:

> Paragraph (i)(1) of this section applies to fees (specified fees) that are not treated as discount or as an adjustment to the yield of a debt instrument over the life of the instrument (such as points) in the taxpayer's AFS and, but for paragraph (i) of this section and §1.1275-2(l), would be treated as creating or increasing OID for Federal income tax purposes.[76]

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[73] Proposed Reg. §1.451-3(h)(5)

[74] Proposed Reg. §1.451-1(a)

[75] Proposed Reg. §1.451-3(i)(1)

[76] Proposed Reg. §1.451-3(i)(2)

The regulation continues describing credit fees described in the prior paragraph:

> For example, the following specified fees (specified credit card fees) are described in this paragraph (i)(2):
>
> > (i) A payment of additional interest or a similar charge provided with respect to amounts that are not paid when due on a credit card account (for example, credit card late fees);
> >
> > (ii) Amounts charged under a credit card agreement when the cardholder uses the credit card to conduct a cash advance transaction (for example, credit card cash advance fees); and
> >
> > (iii) Amounts a credit or debit card issuer is entitled to upon a purchase of goods or services by one of its cardholders (for example, interchange fees, which are sometimes labeled merchant discount in certain private label credit card transactions).[77]

EXAMPLE (PROPOSED REG. §1.451-3(I)(3))

Taxpayer C, a credit card issuer, is a calendar-year accrual method taxpayer with an AFS. In 2019, a cardholder uses C's credit card to purchase $100 of merchandise from a merchant and the cardholder earns a reward of 1% of the purchase price of $100 ($1) as part of C's cardholder loyalty program. Upon purchase, C becomes entitled to an interchange fee equal to 2% of the purchase price of $100 ($2). In 2019, C reports the $2 of interchange fees as revenue in its AFS. C's $2 of interchange fees is described in paragraph (i)(2)(iii) of this section. Under paragraph (i)(1) of this section, C must apply the rules in this section before applying the OID rules. See also §1.1275-2(l). Therefore, C's $2 of interchange fees is included in taxable income in 2019, the year it is included as revenue in C's AFS. Under paragraph (c)(6)(iii) of this section, the $2 of interchange revenue is not reduced by the $1 reward. Even if C reports interchange fees net of rewards in its AFS for 2019 ($2 of interchange fee minus $1 reward liability), under paragraph (c)(6) of this section, C includes $2 of interchange revenue in taxable income in 2019. See §§162 and 461(h) for the treatment of the reward by C.

Treatment of Adjustments to Deferred Revenue in an AFS

If an item is treated as an item of deferred revenue in the taxpayer's AFS and it later adjusts the item, moving it directly to an equity account, revenue for the subsequent year is treated as including that adjustment.[78]

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[77] Proposed Reg. §1.451-3(i)(2)

[78] Proposed Reg. §1.451-3(j)(1)

EXAMPLE (PROPOSED REG. §1.451-3(J)(2))

Taxpayer D, a remanufacturer of industrial equipment, is a calendar-year accrual method taxpayer with an AFS. In 2018, D enters into a contract with a customer to remanufacture equipment in 2019 and 2020 for $100x. The contract is not a long-term contract under section 460. In its 2018 AFS, D treats the $100x as deferred revenue. In 2019, all the stock of D is acquired by an unrelated third party. In its 2019 AFS, D adjusts deferred revenue to $90x (the expected cost to provide the services) by charging $10x ($100x - $90x = $10x) to retained earnings. In its 2019 AFS, D includes $50x of the $90x of deferred revenue in revenue. Under paragraph (j)(1) of this section, D's adjustment to deferred revenue in 2019 is treated as revenue under paragraph (c)(4) of this section in 2019. Therefore, under the AFS income inclusion rule in paragraph (b) of this section, D is treated as including $60x ($50x + $10x = $60x) in revenue in its 2019 AFS, and the all events test is met for that $60x no later than D's 2019 taxable year.

Cumulative Rule for Multi-Year Contracts

Similarly, for a multi-year contract, a taxpayer is required to take into account amounts included in income in prior years in determining the amount included for the taxable years remaining in the contract.[79]

Method of Accounting Issues

A change in the method of recognizing revenue for an AFS that changes or could change the timing of the recognition of income for Federal income tax purposes is a change of method.[80]

The regulations contain special first-year rules for changes in accounting under these regulations, one set for OID changes (for the first year beginning after December 31, 2018) and a second for all other changes (for the first year beginning after December 31, 2017).[81]

The IRS released Revenue Procedure 2019-37[82] that provides automatic permission procedures for taxpayers making the change to use the new advance payment codified rules under IRC §451(b). Note that the procedure offers taxpayers options to either use a §481(a) or cut-off adjustment in most cases.

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[79] Proposed Reg. §1.451-3(k)

[80] Proposed Reg. §1.451-3(l)(1)

[81] Proposed Reg. §1.451-3(l)(2) and (3)

[82] https://www.irs.gov/pub/irs-drop/rp-19-37.pdf, September 6, 2019, retrieved September 7, 2019

Effective Date

While the regulations will be generally effective for taxable years beginning after the date the regulations are published as final in the *Federal Register*.[83] But the rules provide that for most of the rules, taxpayers may rely on the proposed regulations for tax years beginning after December 31, 2017. However, for rules related to specified credit card fees can be first applied to tax years beginning after December 31, 2018, and the early application rules do not apply to other specified fees.[84]

The general effective date for other specified fees is to be delayed by one year, years beginning after the date that is one year after the date the regulations are published in the *Federal Register*.[85]

Items for Which the IRS Did Not Provide Guidance

The IRS did not provide special guidance related to the application of the AFS income inclusion rule to foreign persons. However, in the preamble the IRS requests comments on whether guidance is needed, noting:

> The proposed regulations do not include special rules regarding the applicability of the AFS income inclusion rule to foreign persons. The Treasury Department and the IRS are aware that applying the AFS income inclusion rule to a controlled foreign corporation (CFC) may create mismatches between the CFC's taxable income for U.S. Federal and foreign tax purposes. As a result, certain taxpayers may lose the ability to credit foreign taxes imposed on a CFC's income, particularly where such taxes relate to amounts includible in gross income under section 951A and are therefore ineligible to be carried back or forward under section 904(c). Comments are requested regarding whether special rules are needed to address the applicability of the AFS income inclusion rule to foreign persons, including whether and how the rules for determining the taxable income of a CFC can be adjusted to better align the U.S. Federal and foreign income tax bases.[86]

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[83] Proposed Reg. §1.451-3(n)(1)

[84] Proposed Reg. §1.451-3(n)(3)

[85] Proposed Reg. §1.451-3(n)(2)

[86] REG-104870-18, https://s3.amazonaws.com/public-inspection.federalregister.gov/2019-19325.pdf, release September 5, 2019, scheduled for publication September 9, 2019, retrieved September 5, 2019, pp. 4-5